Banking reform in the UK

John Vickers
All Souls College, Oxford University
Banking reform: plan of remarks

• What went wrong?

• Banking reform in the UK

• Structural reform – ring-fencing

• The bank capital controversy
What went wrong?
The financial system and role of banks

• The financial system supports the wider economy by:
  – providing payments systems
  – providing deposit-taking facilities and a store-of-value system
  – lending to households, businesses and governments
  – helping customers manage risks &c

• Banks play a central role in all of these functions

• Banks can be especially sensitive to economic shocks
  – take on credit risk, and market and maturity/liquidity risks
  – operate with (much) more debt than non-financial firms
Bank funding – the leverage question

**Box 4.1: The impact of higher leverage on return on equity**

<table>
<thead>
<tr>
<th>Bank A</th>
<th>Bank B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank A has 100 assets, funded by 70 deposits, 20 bonds and 10 equity.</td>
<td>Bank B has 100 assets, funded by 70 deposits, 25 bonds and 5 equity.</td>
</tr>
<tr>
<td>Leverage is 100/10 = 10</td>
<td>Leverage is 100/5 = 20</td>
</tr>
<tr>
<td>If the value of the assets rises to 101, the equity gains 1 in value.</td>
<td>If the value of the assets rises to 101, the equity gains 1 in value.</td>
</tr>
<tr>
<td>Deposits 70</td>
<td>Deposits 70</td>
</tr>
<tr>
<td>Bonds 20</td>
<td>Bonds 25</td>
</tr>
<tr>
<td>Equity 10</td>
<td>Equity 5</td>
</tr>
<tr>
<td>Return on equity: 1/10 = 10%</td>
<td>Return on equity: 1/5 = 20%</td>
</tr>
</tbody>
</table>

Higher leverage magnifies returns and losses on equity. The equity of a highly leveraged bank would be wiped out by a smaller shock than would wipe out the equity of a less leveraged one.
Increase in UK bank leverage in the past fifty years

Ratio of total assets to shareholders’ claims.
Relative sizes of banking sectors

Domestic banking assets as a percentage of GDP consolidated by nationality of headquarters (2009)
Banking system ill-prepared for global financial crisis

• Individual banks were huge yet unable to withstand severe economic shocks – thin equity, debt not loss-absorbent

• The bulk of losses of UK banks were overseas

• Financial system highly interconnected – both within and between systemically important banks – no fire breaks

• Core banking services had to be maintained, so Government forced into providing unprecedented levels of support – taxpayer massively on the hook

• Even so, the disruption in economic activity has had a huge and lasting effect on economic growth and the public finances
The crisis greatly weakened the UK economy

• Output took nearly six years to recover to pre-crisis level

• Unemployment increased but not massively, and has fallen back

• Severe implications for public finances

• Productivity growth has been very weak – why?

• Eurozone crisis since 2010 has also depressed the UK economy

• And now uncertainties from Brexit
UK output: potential and actual output forecasts in 2008 and 2015-6

Office for Budget Responsibility, March 2016
UK productivity slump
Eurozone sovereign debt crisis 2010-13

Banking reform in the UK
Wider reform of financial services

- Regulatory architecture
- Macro-prudential regulation
- Shadow banking
- Market infrastructure
- Accounting standards
- Ratings and ratings agencies
Banking reform

- **Structural reform** – should retail and investment banking be separated, and if so how?
- **Loss-absorbency** – how much equity capital and loss-absorbing debt should banks be required to have?
- Liquidity
- Resolution regimes

- Competition

- Other initiatives – supervision, corporate governance, sanctions, pay, taxation, ...
Independent Commission on Banking

• ICB created by the Chancellor of the Exchequer in June 2010
• Members – Clare Spottiswoode, Martin Taylor, John Vickers, Bill Winters, Martin Wolf. Supported by fourteen officials
• Reported to Government on 12 September 2011

• Aims:
  – Financial stability
  – Competition
• Issues of UK competitiveness and fiscal risks
ICB overview of reform options for financial stability

<table>
<thead>
<tr>
<th>Loss-absorbing capacity</th>
<th>Structural reform</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mild</td>
<td>Radical</td>
<td></td>
</tr>
<tr>
<td>Mild</td>
<td>Fails to solve stability problem</td>
<td>Taxpayer on the hook for UK retail banking</td>
<td></td>
</tr>
<tr>
<td>Radical</td>
<td>Fails to shield retail banking from risks elsewhere, real risk of geographic arbitrage</td>
<td>Goes further than needed, real risk of geographic arbitrage</td>
<td></td>
</tr>
</tbody>
</table>
Need for a package of measures

• Best way to achieve aims is by combining moderate measures on loss-absorbency and structure, rather than taking extreme measures on any one front

• Main ICB financial stability recommendations were:
  – Ring-fencing retail banking
  – Increasing the loss-absorbing capacity of banks, through additional equity, loss-absorbing debt and depositor preference

• These proposal interlock with and reinforce international regulatory developments led by FSB and others
Structural reform – ring-fencing
Broad structural options

• Unstructured universal banking

• Structured universal banking

• End universal banking (‘Glass-Steagall’)

• Ban proprietary trading (‘Volcker rule’)

• Functional (retail/investment banking) and geographic aspects
Economics of separation

• Helps *insulate* vital retail banking services – where continuity of service is essential – from global financial shocks. So deals with some interconnectedness risks

• Makes it easier and less costly to *resolve* banks that still get into trouble despite greater loss-absorbing capacity. All part of getting taxpayers off the hook

• Good for *competitiveness* (in ICB’s UK context) because retail banking can be made safer while (subject to resolvability &c) international standards apply to global activities

• Sound long-run framework for bank lending to real economy
Structure

- **US:** Dodd-Frank Act including Volcker rule ban on proprietary trading

- **UK:** Banking Reform Act 2013 to implement ICB ring-fence

- **France/Germany:** Volcker-lite

- **EU:** Liikanen report (2012) and EC response (2014)
# ICB ring-fence design

## Core
- Deposits and overdrafts to individuals and SMEs

## Permitted
- Deposits and payments for any EEA customer
- Non-financial lending, trade and project finance and advice to EEA customers

## Excluded/prohibited
- Any non-EEA services
- Most trading and underwriting of derivatives and debt, asset-backed or equity securities
- Lending to financial companies
Ring-fencing v full break-up

• Ring-fencing retains many of the synergies of a broad banking group, while providing some insulation for vital economic functions
• With ring-fencing the parent group could still rescue a failing retail bank
• Full split would create undiversified, correlated, stand-alone retail banking sector – stability risk
• Go for **structured universal banking**, not ending universal banking – more robust than **unstructured universal banking**
• Scope for broad trans-Atlantic convergence on structured universal banking
Why not the Volcker rule for the UK?

• Proprietary trading should indeed be separated from retail banking

• But that doesn’t go far enough to deliver the insulation, resolution, and public finance benefits of ring-fencing

• The bulk of global wholesale/investment banking – and its risks – would still be comingled with everyday retail banking

• Drawing line between market-making/hedging and prop trading is hard, and more controversial with an absolute ban

• Don’t view Volcker in isolation – the US is different in respect of regulation as well as banking systems
Parliamentary Commission on Banking Standards

• In July 2012, following the LIBOR revelations, the Parliamentary Commission on Banking Standards was established to look at standards issues

• Also scrutinised draft Bill

• Recommended that ring-fence has better chance of working, and for longer, if ‘electrified’ – by reserve power to split individual institutions

• Considered whether Volcker should be added to ring-fencing; on balance not
Banking Reform Act 2013

• Regulatory objectives to include the continuity of provision in the UK of core services (notably deposit and overdraft facilities)

• Ring-fencing
  – ‘ring-fenced body’ = UK institution that does core activities
  – may not do excluded activities (such as dealing in investments as principal)
  – nor contravene prohibitions (e.g. concerning kinds of transaction, non-EEA branches, ownership stakes)
  – ring-fencing rules being made by Prudential Regulation Authority on transactions, payments, disclosures, board independence, &c

• Depositor preference for insured deposits

• Other elements of Act
The bank capital controversy
Capital and loss-absorbency

- Market system works well only if those who get rewards in good times absorb losses in bad times.
- Standard bankruptcy does not work for systemically-important banks because of the core service continuity imperative, deposit insurance &c.
- So normal hierarchy of loss-absorption (equity → debt → ...) became equity → taxpayer, and with wafer-thin equity.
- Huge implicit subsidy and distortion of incentives.
- Moreover, with unstructured universal banks, the home taxpayer is on the hook for the lot, and with no firebreaks.
Is equity costly to banks?

• Is bank equity costly (1) for banks, and (2) for the economy?

• Yes

• Debt/equity tax wedge – how big a deal?
• Debt overhang
  – spill-over benefit to creditors, and to public (contingent) creditor in particular
  – especially if equity is thin

• But these aren’t costs to the economy
Is bank equity costly to the economy?

• Is bank equity costly (1) for banks, and (2) for the economy?
• MM theorem says No – for given risks in the economy, why would the aggregate value of claims depend on debt/equity mix?
• Reality ≠ MM, but …
  – social costs of bankruptcy argue for more equity
  – so do incentive reasons, including
    – getting the taxpayer off the hook, which is necessary (but not sufficient) for good economic incentives towards risk

• But how far to go?
• Answer depends on national (ICB) v global (Basel) perspective
Policy on bank capital

- Basel III makes major progress on capital but is unambitious, despite uplift for globally systemic important banks
  - equity capital $\geq 7\%$ of “risk-weighted assets” (up to 9.5% for GSIs)
  - leverage $\leq 33$ backstop
- ICB recommended 10% (and 25x backstop) for large retail banks plus other measures
- BoE’s disappointing 2016 policy on the ‘systemic risk buffer’
- Progress on loss-absorbing debt and resolution regimes
Why didn’t the ICB recommend more capital?

- ICB recommended 10% minimum equity ratio to RWAs for large retail banks, accompanied by 25x leverage cap.
- We faced three constraints
  - geographic arbitrage
  - institutional arbitrage from banks to non-banks
  - the problem of transition
- My blue-sky numbers would differ by a factor of two, but the skies are cloudy
- Importance of banks having further ‘primary loss-absorbing capacity’ (e.g. including bail-in debt) well beyond the equity minimum. Also preference for (insured) deposits.
Bank of England policy on equity capital for major retail banks

• Policy on ‘systemic risk buffer’ announced on 26 May 2016

• Major banks will be required to hold some extra equity capital ... but not much

• For a critical assessment of this policy see my JFR paper

• It places too much faith in new and untried resolution regimes, and in active counter-cyclical buffer policy (which has shifted post-referendum)

• Capital requirements for major retail banks should be much greater than the BoE has decided
Brexit and the banks

- Big falls in *bank* share prices after the referendum but some recovery since

- Recession risk
- Unemployment risk
- Property price risk

- Interest rates lower for longer

- Uncertainty about future access to European markets
Bank share price movements

Indices: 20 November 2015 = 100

- Core euro area (b)
- United Kingdom
- Spain
- Portugal
- Italy

Bank reform: job done?

“The job is now substantially complete”
– Mark Carney to G20 Leaders, November 2014

I don’t think so:
• Basel III is too weak, e.g. on leverage
• BoE has softened its position on capital requirements
• Europe might duck serious structural reform
• Brexit has heightened risks
• So lots of unfinished business